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Third-Party Logistics: The Industry That Needs to Relax

For further information:
Marco Kesteloo, Amsterdam: marco.kesteloo@booz.com
Robert Spieker, Amsterdam: robert.spieker@booz.com
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Third-Party Logistics: The Industry That Needs to Relax

By tailoring technology solutions to each client's needs, logistics operators are doing unnecessary damage to their margins.

by Damian Coffey, Marco Kesteloo, and Robert Spieker

Imagine creating a business strategy based on fulfilling the expressed needs of your customers in order to gain their loyalty, but then finding that your margins have gone into free fall. This can be a common phenomenon at individual companies, especially in commoditized manufacturing industries such as consumer electronics and semiconductors. But what happens when the problem suddenly engulfs an entire business-to-business services industry?

The $100 billion third-party logistics industry assembles and transports all kinds of goods for a wide variety of manufacturers and retailers. Much like the Internet, which moves the information on which all business now relies, third-party logistics companies have created a platform — or, rather, a vast number of interconnected platforms — on which the global economy increasingly depends. But unlike the innovative companies, such as Google, Yahoo, and Amazon, that have carved out profitable brand positions on the Internet, these logistics operators have not differentiated themselves enough to keep profits growing. How could they, given that the industry's business model consists primarily of custom-tailoring technology solutions to clients' every request, without thought given to the economic consequences of that strategy? The upshot is that the industry is now trapped in a downward spiral of cutthroat competition, expensive project-by-project customization, and declining margins: From 1996 to 2005, the average return on sales across a representative sample of the leading players dropped by more than half, from 6.4 percent to 2.6 percent.

Ironically, the industry's customers, the manufacturing companies that outsource to third-party logistics companies, have had to solve this problem in their own industry. But most third-party logistics providers have not yet learned to relax their customer-centric business model and consolidate their technologies in a less expensive, less frenetic, and more productive way of operating. To do so would mean relinquishing the prevailing project-focused industry approach (where every new customer project gets all new designs and implementation) in favor of a product-focused model that offers a carefully defined and delimited selection of increasingly differentiated (and thus more profitable) services. By giving up their "customer is always right" approach to services and instead embracing a more disciplined and strategic "smart customization" approach, third-party logistics providers can pay more careful attention to the real needs of their customers. They can reduce the complexity and cost generated by unfettered acquiescence to their customers' perceived needs, and make their own industry more viable in the bargain.

Damian Coffey
(coffey_damian@bah.com)
is a senior associate with Booz Allen Hamilton based in London. He focuses on assignments in the postal, logistics, and transportation industries, and has extensive supply chain and operations experience with a wide variety of clients across industry sectors.

Marco Kesteloo
(kesteloo_marco@bah.com)
is a vice president with Booz Allen Hamilton based in Amsterdam. He focuses on assignments in the areas of strategy, operations, and organizational management, and has extensive supply chain experience with a wide variety of clients across the logistics industry, as well as their customers.

Robert Spieker
(spieker_robert@bah.com)
is a principal with Booz Allen Hamilton based in Amsterdam. He focuses on assignments that leverage sourcing, supply chain, and logistics to drive performance improvement, and has extensive experience with logistics, consumer products, and retail industry clients.

Consider the typical flow of kitting orders that third-party logistics firms receive from mobile phone operators. A phone company may place no orders on one day, then demand tens of thousands of phones on the next. The logistics firm's service-level agreement may require it to finish all the phones in each order in one day, whether or not they're all urgently needed. Thus the deal may force the logistics firm to build excess capacity and direct scant resources solely to cover the peaks in demand, even though many of the phones may sit in a warehouse for weeks. Wouldn't it be better to sit back, think strategically about the client's needs, and then put together a service-level agreement that more intelligently meets those needs? Doing so means taking a consultative approach to selling, whereby experts can evaluate the impact of trade-offs jointly with their customers, based on a strong understanding of both the operating costs and the value to customers.

That's the goal of smart customization, an approach that has worked well for one leading global third-party logistics provider. The company began by piloting the program in just a few warehouses, and the results were so strong that it has now extended the strategy throughout the company. The company developed a suite of modular high-value "products," such as reverse logistics (the handling and processing of returned goods) and flexible kitting, that it can now offer to customers on a more cost-effective basis after analyzing those customers' real needs. At the same time, it worked toward implementing standardized IT systems and configurations, particularly in warehouse management systems, throughout the company, reducing the expense of developing and operating redundant systems. And the company is leveraging the lessons learned across separate geographical and industry-specific business units, breaking down the barriers that kept its engineering efforts widely decentralized.

The company has seen dramatic productivity gains in the warehouse tests, and improvements in the time it takes to implement new contracts. The challenge now will be to reap those benefits throughout the company, and that will require the entire organization — from the designers of customer "products" to IT and operations, to business development and the sales force — to relax efforts to respond to every customer request, replacing that tactic with the strategic goal of cost-effective modularity.

Can such a strategy save the entire global third-party logistics industry? That depends on how the industry copes with two endemic problems that arise directly out of the self-defeating urge to customize every customer contract. First, leading players are consolidating across national borders to gain global reach. Yet the efforts to integrate acquisitions into their global networks have not generally been successful, leaving many industry players to stumble along as loosely connected networks of national or regional businesses. That, in turn, has kept them from effectively sharing contacts, knowledge, and good practices throughout the company, and has supported the practice of creating individual solutions to every customer request.

The second problem is an outgrowth of the first. Despite the critical role of information technology in their business, third-party logistics firms are inefficient users of IT. Thanks in part to their poor integration of acquisitions and in part to their undisciplined use of outsourcing, some operators continue to support as many as 80 separate warehouse-management systems. Their unwillingness to consolidate systems has led to unsustainably high cost structures, and the resulting complexity just erodes margins further.

On a company-by-company basis, smart customization can help solve the first problem by requiring company-wide strategic responses to customers' real needs, and the second problem by forcing companies to develop modular, high-value, IT-intensive products that sit on top of a common, and much less costly, company-wide IT infrastructure.

If smart customization were to spread throughout the industry, the competitive landscape would change dramatically. Companies might find that more extensive partnering, based on the need to fill gaps in their modular offerings or industry-specific expertise, would be to their mutual advantage. And ultimately, perhaps, the industry would evolve a single, interoperable platform for the most highly commoditized parts of its business, enjoying profits thanks to the higher margins generated from the parts that have been customized, smartly. +

Resources

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